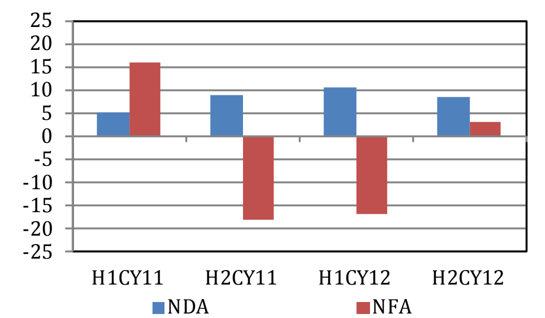
The unresolved economic issues mainly twin deficits (fiscal and trade) continued to affect the domestic financial markets. Specifically, the money market remained rather stressful due to volatile liquidity profile amid higher demand for budgetary financing. The foreign exchange market also exerted some vulnerability due to deleting foreign exchange reserves on account of repayments of foreign loans, which lead to modest 2.6 percent (PKR/USD) depreciation of domestic currency. Similarly, the equity markets continued to exhibit strong growth as KSE-100 index improved by 22.5 percent during H2-CY12.

Twin deficits continued to pose stress on financial markets

Stress continued to prevail in the domestic financial markets despite improvements in some macroeconomic indicators. More than expected decline in CPI and a moderate LSM growth of 2.1 percent during H2-CY12 raised some optimism among the market participants; however, persistently high fiscal deficit and declining foreign exchange (FX) reserves severely affected the domestic financial markets.

Figure 5.1

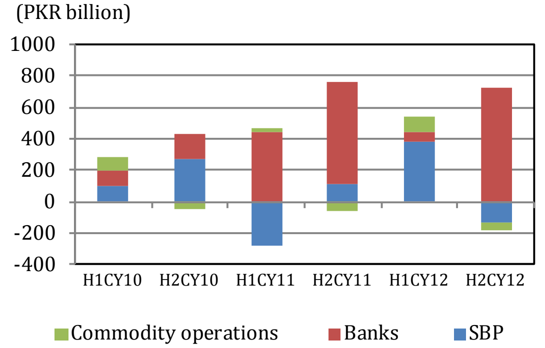
Trends in Components of M2 (half-yearly percentage change)



Like the first half of the year, much of the pressure in the financial markets during H2-CY12 stemmed from an unprecedented demand for funds from the government. This high demand for funds made the market liquidity management quite challenging as average overnight rate hovered around the upper bound of the interest rate corridor. The volatility in the market remained high despite a 250 reduction in the policy rate and a 50 bps decline in interest rate band during H2-CY12.

Figure 5.2

Pattern of Government Borrowings - Half-Yealy Flows (PKR billion)



The foreign exchange market witnessed some temporary ease as services inflows improved on account of Coalition Support Fund (CSF) and the current account again went into positive territory. These developments translated into relatively milder deprecation of 2.6 percent in PKR against USD in the interbank market during H2-CY12 compared to 4.4 percent in H2-CY11. However, the import coverage ratio further worsened owing to depleting FX reserves mainly on account of repayments of IMF loans. The equity markets continued bullish run as the benchmark KSE-100 index rose by 22.5 percent during the H2-CY12.

The changes in the M2 (money supply) during H2-CY12 followed the prevailing trend of rising NDA – Net Domestic Assets (**Figure 5.1**). Meanwhile, the NFA (Net Foreign Assets), after contracting throughout FY12, grew by 3.1 percent owing to banks' accumulation of Nostro balances held abroad. The NFA of the central bank (SBP) decreased on account of reduction in the reserves due to loan repayments.

Figure 5.3

Trend of overnight Repo Rates (percent)

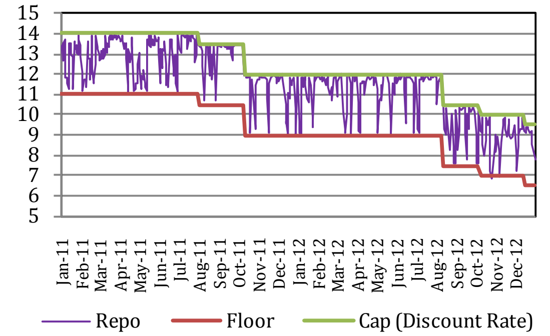


Figure 5.4

Outstanding Open Market Operations (PKR billion)

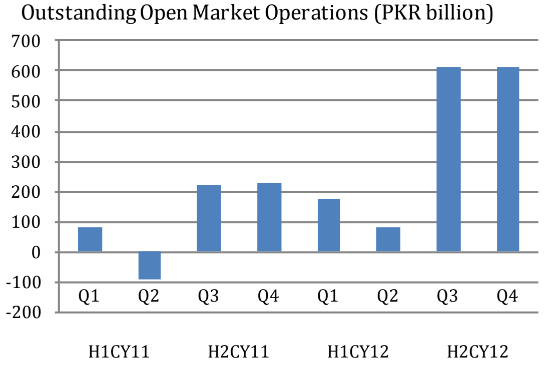
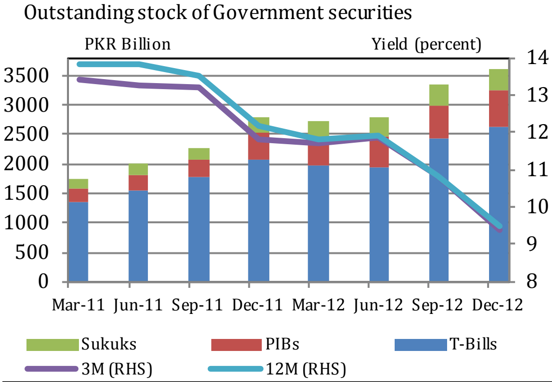


Figure 5.5

Outstanding stock of Government securities



On the other hand, 8.4 percent surge in the NDA resulted from an unprecedented public sector budgetary borrowing (Government and PSEs) from the commercial banks during the period. The deficit widened on account of sluggish tax collection coupled with rising interest payments on domestic public debt. As a result, government borrowings from the banking system increased by 34.6 percent during H2-CY12 against 31.0 percent during the corresponding period of the last year (**Figure 5.2**). However, government retired 8 percent of the SBP borrowing. Similarly, the seasonal commodity financing also witnessed 9.9 percent net retirements during the period as public sector procurement departments substantially offloaded the wheat stock.

Unlike the first half, when most of the increase in advances resulted from public sector borrowings, the second half saw improvement in disbursement to the private sector, mainly for working capital finance, which complemented the growth of the NDA.

Money Market

Central bank injections continued to restore money market liquidity

The constant rollover of debt by the government in addition to new short-term funding needs posed concern for the already vulnerable market liquidity. As a result, the interest rates in the overnight repo market remained higher than the mid of the interest rate corridor for a large number of trading days (**Figure 5.3**).

In order to ease out the market, the central bank made substantial liquidity injections during H2-CY12 thus indirectly monetizing the fiscal deficit. During H2-CY12, the volume of open market injections exceeded PKR 600 billion (**Figure 5.4**). The injections though had a direct bearing on the increased reserve money; it did not pose significant risk towards inflation, due to declining inflationary trend (in the range of 7 to 9 percent during H2-CY12). Furthermore, the central bank (SBP) also took some policy measures to ensure stable market liquidity[62]

[62] The SBP restricted the eligible financial institutions towards approaching the discount window not more than 7 times during a quarter. In case the banks and other eligible financial institutions approach the repo and reverse repo facilities by more than 7 times, a spread of 50bps is applied over and above the overnight repo and reverse repo rates for the remainder of the same quarter. Source: DMMD Circular No. 20 of 2012, State Bank of Pakistan

Figure 5.6

Profile of T-bill Auctions (PKR billion)

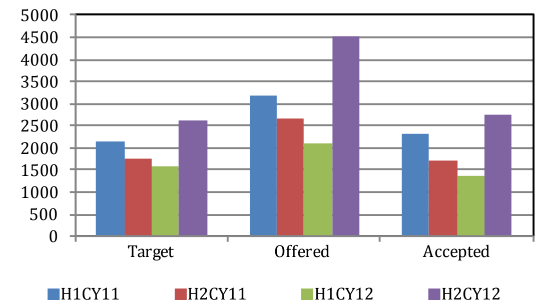


Figure 5.7

T-Bill Tenure offered (percent share)

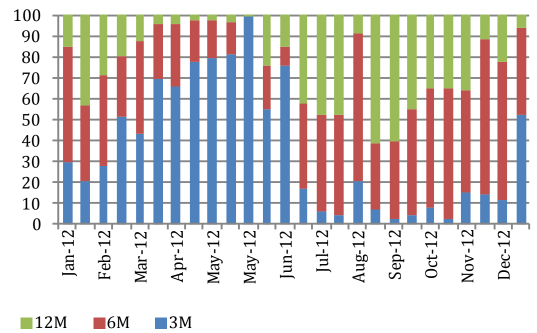


Figure 5.8

Growing share of Non-Competitive Bids

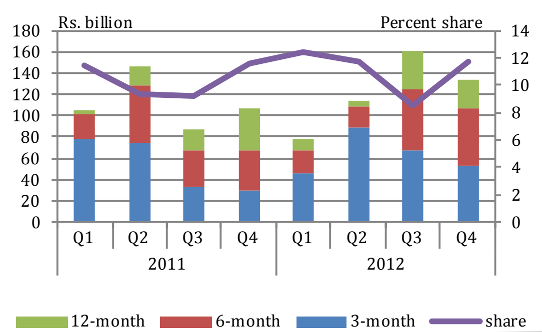
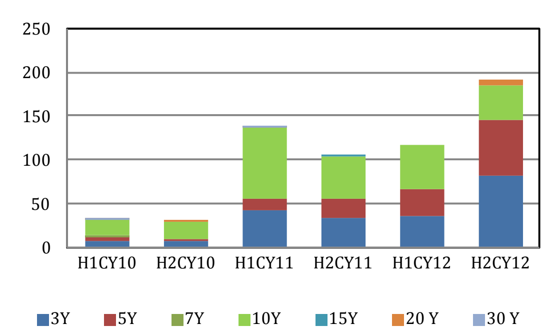


Figure 5.9

Accepted PIB Auction Profile (PKR billion)



Government borrowings from banking sector reached new high

Increasing government appetite for funds and subdued private sector financing provided banks with risk free avenue of investments. Banks' interest in government securities prevailed despite sharp dip in yield on government securities in the period under consideration. The banks invested heavily in short term instruments and the outstanding investments in T-bills rose by another 34.8 percent (**Figure 5.5**).

Likewise, banks' concentration in government securities (share in total investments) further increased to 79.9 percent in H2-CY12 from 70.7 percent. An increased appetite of banks also reflected in high offered to target ratio, which increased from 134 percent in H1-CY12 to 173 percent in H2-CY12. Such a high exposure in public securities exposes banks to various risks and needs to be contained to avoid any adverse affect on performance of the banking system[63].

The pattern of offered amounts in T-bills also revealed increased reliance of the government on banks for short term funding needs. The amount targeted in T-bills auctions witnessed a considerable growth during H2-CY12 as the government deficit widened and the lags in revenue generation worsened further. The government accepted more than the required funds, which considerably increased the acceptance to target ratio to 104.8 percent in H2-CY12 from 85.6 percent in H1-CY12 (**Figure 5.6**).

The pattern of offered amount in T-bills of various maturities varied distinctively between the two halves of CY12. The first half saw the domination of shorter tenor maturity of 3-month instruments while most of the second half observed surge in the 6-month T-bill offerings. One reason for movement from 3-months to 6-months was the 150 bps drop in the policy rate in Aug 2012. It was higher than the market's expectations and therefore the market didn't anticipate any further rate cut during the year and resorted to 6-month instrument. While investments in12-month securities almost dried down during the later part of CY12 as expectations of further rate cut resurged (**Figure 5.7**).

In addition to the financial institutions, the interest of individual investors in T-bills also gathered momentum during H2-CY12. The offered amount in T-bills auction through Non-Competitive Bids (NCBs) witnessed an improvement of 53.6 percent (**Figure 5.8**). Rising volumes in the NCBs indicated the steps taken by the

[63] The risks associated with investing in government securities such as reinvestment risks are discussed in chapters 1 and 3.

Government in providing investors an alternative avenue for risk-free investments[64].

In addition, the government also borrowed from the auction of longer-term Pakistan Investment Bonds (PIBs). The higher yield on long-term instruments provided opportunity to financial institutions including banks to invest in risk free long-term instruments. As a result, the stock of PIBs increased by 64 percent during H2-CY12. Further, investment was heavily skewed in 3-year and 5-year bonds due to uncertain global and domestic economic environment. The share of 3-year bond in total PIBs stock surged to 43 percent by end of H2-CY12 (**Figure 5.9**).

Unlike T-bills and the PIBs, the auction profile of Ijarah Sukuks remained subdued. The government accepted merely 44 percent of the amount offered (**Figure 5.10**). Given the features of Ijarah Sukuks, the supply of Islamic instruments are severely restricted as they are issued on the back of real assets. Since the Government had already issued a considerable volume of Sukuks during the first half, Sukuk issuance remained tepid during the second half of CY12.

The changes in monetary stance during the half year CY12 significantly impacted the slope of the yield curve. A 250 bps reduction in the policy rate reduced the short term rates by a rather large proportion. For instance, the 1-month PKRV rates declined by 262 bps during the period while the 6-month rate declined by 276 bps. However, the changes in the interest rates remained less pronounced on longer term maturities (**Figure 5.11**).

Figure 5.10

Auction Profile of Ijara Sukuk (PKR billion)

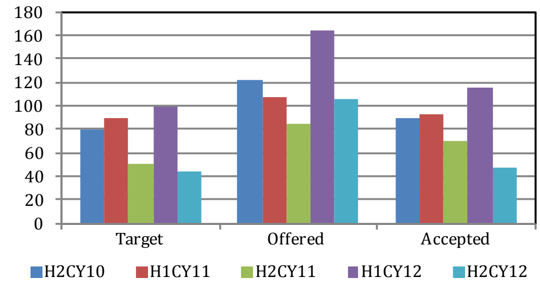


Figure 5.11

Yield Curve (percent)

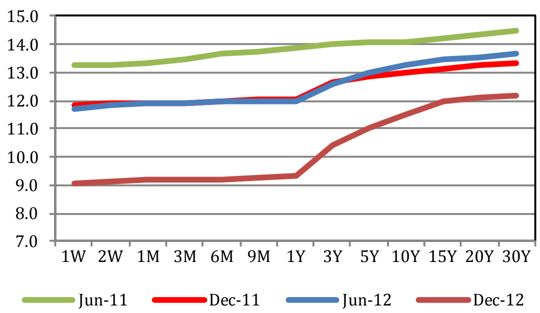


Figure 5.12

Developments in External Account

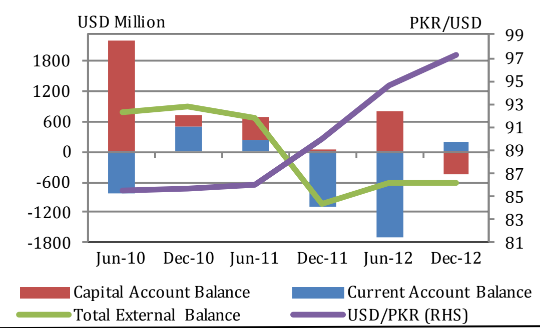
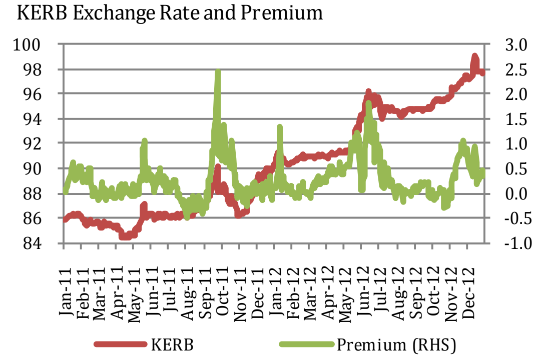


Figure 5.13

KERB Exchange Rate and Premium



Foreign Exchange Market

FX market sentiments eased out by timely CSF flows

In contrast to stressed money market, the foreign exchange market (FX) maintained a mixed picture. On a positive side, the current account balance was positive largely supported by the receipt of Coalition Support Fund (CSF), reduction in trade deficit and increasing workers' remittances. Meanwhile the financial account witnessed a deficit on account of fall in foreign borrowings. As a result, the overall external account balance deteriorated marginally by USD 0.5 billion during H2-CY12 as

[64] The government stimulated the public interest in the NCBs by regular advertisements in local newspapers highlighting salient features and benefits of investing in government securities. Further, the SBP also increased ratio of NCBs from 10 percent in Jul FY03 to 15 percent in July FY10.

Figure 5.14

Foreign Exchange Reserves and Import Coverage

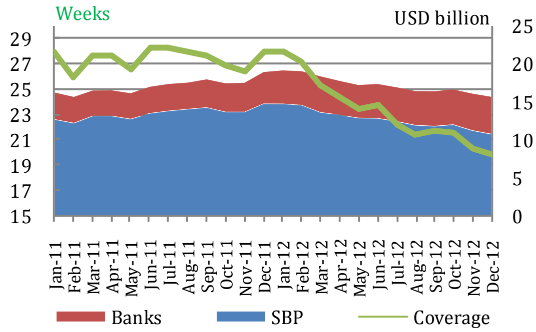


Figure 5.15

KSE-100 Index and Trading Volumes

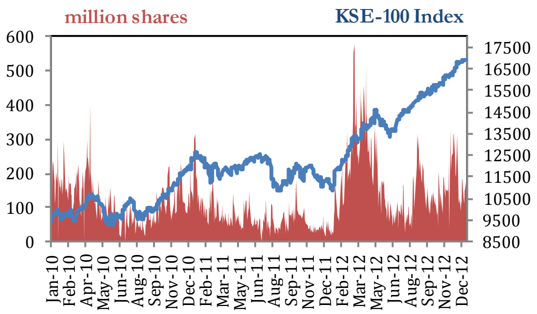


Table 5.1

Improved Corporate Profitability (before tax)

				PKR billion
	2009	2010	2011	2012
Oil and Gas	120.13	162.11	196.11	240.54
Banks	82.89	107.84	158.82	172.17
Chemical	34.89	44.26	70.37	54.45
Cement	6.95	-5.63	4.2	24.58
Food	3.41	18.47	24.56	28.83
Power	-2.656	-0.917	5.43	23.23
Textiles	-3.463	30.54	35.43	16.51
Auto	4.704	7.47	7.65	11.19
Telecom	15.12	11.12	4.88	10.23
Insurance	4.82	4.65	5.51	9.6
Pharma	3.69	5.21	6.44	7.71
Engineering	8.53	11.52	9.03	5.87
Mod/ MF	-13.38	2.82	4.95	3.73
Transport	2.87	2.66	3.02	1.92
NBFC	-28.91	-10.515	-2.33	1.64

against a negative balance of USD 1.4 billion during the first half CY12 (**Figure 5.12**).

Despite a relative improvement in external balance, the foreign exchange reserves kept on depleting during H2-CY12, mainly on account of repayments to IMF. This adversely impacted the import coverage ratio which declined to 18.1 weeks in Dec-12 from 22.3 weeks in Jan-2012 (**Figure 5.14**).The continuous decline in reserves in near future along uncertain financial inflows and heavy repayments to the IMF may eventually lead to higher exchange rate movements in the KERB market.

Central bank injections also moderated currency depreciation

Though both interbank and KERB remained volatile due to adverse impact of the decline in reserves, the CSF flows and SBP interventions eased out the FX market sentiments. The Pak Rupee, therefore, saw a modest depreciation of 2.6 percent interbank market and even lesser depreciation in the KERB rate (2.2 percent). As a result, the premium between KERB and interbank market, which jumped to above 1 percent in November CY12 dipped to less than 0.5 percent by the end of CY12. The average premium reduced to PKR 0.25 during H2-CY12 as against PKR 0.45 in the first half of CY12 (**Figure 5.13**).

In addition to the reserves held with the central bank, the Foreign Currency Deposits (FE-25) held with the banks also contributes towards FX reserves. Though FCD improved marginally by 0.9 percent during H2-CY12, a decline in FC lending / financing improved the liquid FC reserves held with the banks by 8.6 percent[65]. While the inflows remain uncertain, the liquid FX reserves held with the banks served as a useful cushion again unexpected price shocks in terms of trade.

Capital Market

KSE continued to boost on the back of corporate earnings

The performance of the equity markets remained robust in the second half of CY12, as benchmark KSE-100 index witnessed a growth of 22.5 percent (**Figure 5.15**). As a result, the share index surged by 49 percent during the CY12, making it one of the best performing stock markets in Asia. The continuation of the momentum in the KSE was on account of improved earnings of the corporate sector, monetary easing, timely receipt of the CSF

[65] The FCD are used by banks to make loans / financing and /or to use as placements and investments. Since the placements and investments are liquid, only loans /financing is deducted from FCD to arrive at calculating liquid FX reserves held with the banks.

Figure 5.16

Net SCRA Flows and KSE Performance

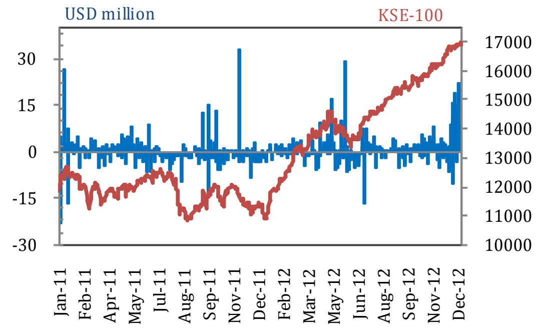


Figure 5.17

Sector-Wise Performance of KSE (percent)

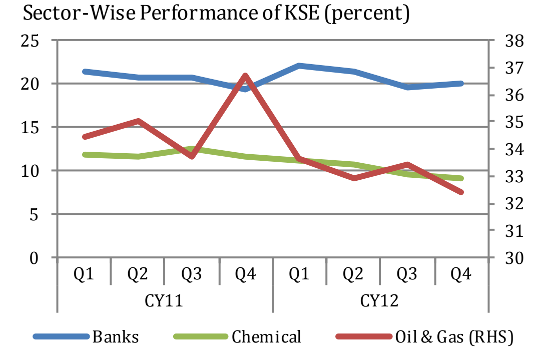


Figure 5.18

Equity Listings in KSE

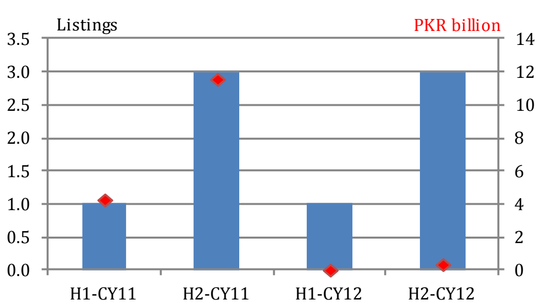
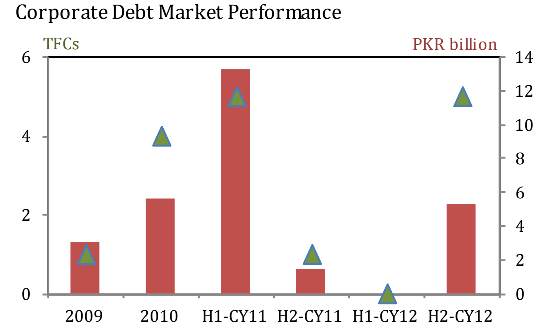


Figure 5.19

Corporate Debt Market Performance



and renewed interest by local and foreign investors and institutions.

Positive sentiments in the market revived the interest of foreign institutional investors; the FPI witnessed a net inflow of USD 160 million in the second half as against an equivalent net outflow in the earlier half CY12. Specifically, the foreign investment as measured by Special Convertible Rupee Account (SCRA) also boosted the equity market sentiment. The SCRA net flows improved from USD 46.6 million during H1-CY12 to USD 246.6 million during H2-CY12 (**Figure 5.16**).

The improvements in the market sentiments also reflected in terms of reasonable level of daily turnover volumes, which on average stood at 147 million shares during H2-CY12. Though volumes remained lower than the first half of CY12, the turnover was in line with the general trend; the average turnover for the first half of the year stood higher than the latter half since CY10.

The growth in the KSE index remained highly concentrated in a few leading sectors like Banks, Chemical, Oil and Energy. Further, the revival of cement sector also provided support to growth in the market indices. Within the corporate sector, nearly all major listed groups posted healthy financial results. The performance in terms of profitability (pretax) of oil and energy sector, which holds the highest share in terms of market capitalization, remained dominant throughout the H2-CY12 (**Table 5.1**). This extraordinary performance led to a decline in the share of banking sector in overall market capitalization to 20.1 percent in Dec-12 from 21.1 percent in Jun-12 (**Figure 5.17**).

Equity and Debt market listings re-emerged

Another positive feature of the capital markets was new listings both in the equity and corporate debt. The equity market saw three new listings worth PKR 385 million (**Figure 5.18**). Furthermore, the debt market also witnessed a revival as three companies, having concentration in energy and telecommunication, listed with a total debt issue size of PKR 5.2 billion (**Figure 5.19**). With an improvement in the stock index and declining yields on government securities, the KSE has been able to attract prospective domestic as well as foreign investors. Though the number of fresh listings and amount of new equity and debt issues were low by historical standards, with the continuation of existing performance of the stocks, it is expected that more listings and debt issues will take place in future.